Municipal Market Comments

Ascent Investment Partners

October 1, 2014

from Montage Investments

New Bank Regulations Could Have Impacts on the Municipal Market

In early September, federal regulators approved new rules that could limit large banks' willingness to hold municipal bonds. In an effort to ensure that banks have sufficient liquid assets to meet their capital needs in a distressed market environment, federal regulators adopted new guidelines defining what qualifies as "high-quality liquid assets" (HQLA) for purposes of calculating available assets. The rules come in response to the liquidity problems that banks faced during the financial crisis. To reduce "systemic risk," the new guidelines specifically target banks with over $250 billion in assets.

Under the new rules, municipal bonds are specifically excluded from the definition of HQLA for large banks, leading some market analysts and issuers to fear that bank demand for munis could suffer. The blanket exclusion of munis comes as somewhat of a surprise given the fact that municipal bonds have far lower default rates than some of the included asset classes, such as investment-grade corporate bonds. In fact, high-grade municipals were one of the few assets classes that continued to trade in a fairly orderly manner during the heights of the financial crisis.

Given that banks hold approximately 11% of the municipal bonds outstanding, it would seem that limiting banks' ability to count municipal bonds as liquid assets would make banks less willing to hold munis. If this were the case, we could anticipate downward pressure on prices (and rising yields) in the sector generally. However, we believe the potential impacts of the new regulations will be modest given:

- The regulations apply to banks with greater than $250 billion in assets, which encompasses only the nine largest banks in the U.S.
- While banks as an industry hold $374 billion of municipal bonds (11% of the $3.7 trillion muni market), less than one-third of that amount is held by the banks subject to the new rules.
- Municipal bonds may continue to offer banks a yield advantage over other high-grade investment alternatives, sometimes even before considering the yield effects of the tax-exemption.
- Banks have significant incentives to buy "bank-qualified" municipal bonds, which are bonds sold by issuers that sell less than $10 million of debt per year, because they offer significant tax benefits to banks of all sizes.*

- If bank selling did cause municipal yields to rise relative to Treasuries and other taxable bond sectors, we would expect robust demand from individual investors and cross-over buyers.
- Due to push back from issuers and banking groups, there are already rumblings that the new regulations may be modified in the future to include some types of municipal bond issues.

While we follow developments in bank regulation with interest, we do not expect the implementation of new capital rules to have a significant impact on the municipal bond yields. Banks have historically been active buyers of municipal bonds and we expect them to remain so. Bank appetite for municipal bonds has recently been extremely strong (since 2007, banks have almost doubled their holdings of municipal bonds), and we expect demand to remain strong unless there is a significant shift in spread relationships between munis and Treasuries (and, to a lesser extent, other taxable bonds). Should there be a rise in rates as a result of declining bank demand for municipal bonds, we would view it as an attractive buying opportunity for investors to add high-quality municipal bonds and increase their portfolio yield.

** Under the provisions of the American Recovery and Reinvestment Act of 2009 (ARRA, commonly known as the Stimulus Bill), the limit for bank-qualified issuers was raised to $30 million from $10 million. Though the limit reverted to $10 million after 2013, there is currently legislation pending Congress that would permanently raise the cap back to $30 million.*

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